



# China-U.S. Trade Issues

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January 7, 2011

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

RL33536

Report Documentation Page				Form Approved OMB No. 0704-0188	
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1. REPORT DATE <b>07 JAN 2011</b>		2. REPORT TYPE		3. DATES COVERED <b>00-00-2011 to 00-00-2011</b>	
4. TITLE AND SUBTITLE <b>China-U.S. Trade Issues</b>				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) <b>Congressional Research Service, The Library of Congress, 101 Independence Avenue SE, Washington, DC, 20540-7500</b>				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT <b>Approved for public release; distribution unlimited</b>					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT <b>Same as Report (SAR)</b>	18. NUMBER OF PAGES <b>37</b>	19a. NAME OF RESPONSIBLE PERSON
a. REPORT <b>unclassified</b>	b. ABSTRACT <b>unclassified</b>	c. THIS PAGE <b>unclassified</b>			

## Summary

U.S.-China economic ties have expanded substantially over the past three decades. Total U.S.-China trade rose from \$2 billion in 1979 to an estimated \$459 billion in 2010. China is currently the second-largest U.S. trading partner, its third-largest export market, and its biggest source of imports. Because U.S. imports from China have risen much more rapidly than U.S. exports to China, the U.S. merchandise trade deficit has surged, rising from \$10 billion in 1990 to an estimated \$273 billion in 2010.

The rapid pace of economic integration between China and the United States, while benefiting both sides overall, has made the trade relationship increasingly complex. On the one hand, China's large population and booming economy have made it a large and growing market for U.S. exporters. Over the past decade, China has been the fastest-growing market for U.S. exports. U.S. imports of low-cost goods from China greatly benefit U.S. consumers by increasing their purchasing power. U.S. firms that use China as the final point of assembly for their products, or use Chinese-made inputs for production in the United States, are able to lower costs and become more globally competitive. China's purchases of U.S. Treasury securities (which stood at \$907 billion in October 2010) help keep U.S. interest rates relatively low. On the other hand, many analysts argue that growing economic ties with China have exposed U.S. manufacturing firms to greater, and what is often perceived to be, "unfair," competition from low-cost Chinese firms. They argue that this has induced many U.S. production facilities to relocate to China, resulting in the loss of thousands of U.S. manufacturing jobs. Some policymakers have also raised concerns that China's large holdings of U.S. government debt may give it leverage over the United States.

China's incomplete transition to a free market economy and its use of distortive economic policies have contributed to growing trade friction with the United States over a number of issues, including China's refusal to allow its currency to appreciate to market levels, its mixed record on implementing its World Trade Organization (WTO) obligations, its relatively poor record on protecting intellectual property rights (IPR), and its extensive use of industrial policies and discriminatory government procurement policies to subsidize and protect domestic Chinese firms at the expense of foreign companies. The United States initiated three WTO trade dispute resolutions against China in 2010, dealing with such issues as China's use of subsidies to promote its wind power industries, its use of trade remedy laws to protect domestic industries, and restrictions on electronic payment services. Some members of Congress have argued that, given the slow rate of U.S. economic growth and the high rate of unemployment, China's distortive trade policies can no longer be tolerated and have called for tougher action to be taken against China to induce it to eliminate policies that hurt U.S. economic interests. These trade frictions may intensify in the future as China attempts to implement policies to increase the output of more advanced products.

Numerous bills were introduced in the 111<sup>th</sup> Congress to address various Chinese economic and trade policies. For example, one bill, which passed the House (but was not taken up by the Senate), would have made certain fundamentally undervalued currencies (such as China's) actionable under U.S. countervailing duty laws (which address government export subsidies). U.S.-China commercial issues may continue to be a major focus in the 112<sup>th</sup> Congress. This report provides an overview of U.S.-China trade relations. It describes the trends in commercial ties, identifies major trade disputes, and surveys legislation that may affect economic relations.

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Economic and trade reforms (begun in 1979) have helped transform China into one of the world's fastest-growing economies. China's economic growth and trade liberalization, including comprehensive trade commitments made upon entering the World Trade Organization (WTO) in 2001, have led to a sharp expansion in U.S.-China commercial ties. Yet, bilateral trade relations have become increasingly strained in recent years over a number of issues, including a large and growing U.S. trade deficit with China, resistance by China to reform its currency policy, U.S. concerns over China's mixed record on implementing its WTO obligations, and numerous Chinese industrial policies that appear to impose new restrictions on foreign firms. Several members of Congress have called on the Obama Administration to take a tougher stance against China to induce it to eliminate economic policies deemed harmful to U.S. economic interests and/or inconsistent with WTO rules. This report provides an overview of U.S.-China economic relations, surveys major trade disputes, and lists bills introduced in Congress that could affect bilateral commercial ties.

## U.S. Trade with China<sup>1</sup>

U.S.-China trade rose rapidly after the two nations reestablished diplomatic relations (in January 1979), signed a bilateral trade agreement (July 1979), and provided mutual most-favored-nation (MFN) treatment beginning in 1980.<sup>2</sup> In 1979 (when China's reforms began), total U.S.-China trade (exports plus imports) was \$2 billion; China ranked as the 23<sup>rd</sup>-largest U.S. export market and its 45<sup>th</sup>-largest source of U.S. imports. In 2010, bilateral merchandise trade was projected to reach \$459 billion; China was the second-largest U.S. trading partner (after Canada), the third-largest U.S. export market (after Canada and Mexico), and the largest source of U.S. imports. In recent years, China has been one of the fastest-growing U.S. export markets, and the importance of this market is expected to grow even further, given the pace of China's economic growth, and as Chinese living standards continue to improve and a sizable Chinese middle class emerges.

The U.S. trade deficit with China has surged over the past two decades, as U.S. imports from China have grown much faster than U.S. exports to China. That deficit rose from \$10 billion in 1990 to \$266 billion in 2008, fell to \$227 billion in 2009, and then rose to an estimated \$273 billion in 2010 (see **Table 1** and **Figure 1**).<sup>3</sup> As can be seen in **Table 2** and **Figure 2**, the U.S. trade deficit with China in 2009 was significantly larger than that with any other U.S. trading partner and several trading groups. For example, it was larger than the combined U.S. trade deficits with the Organization of the Petroleum Exporting Countries (OPEC), the 27 nations that make up the European Union (EU27), Mexico, Japan, and Canada (together they totaled \$235 billion).

<sup>1</sup> For more information on China's economy, see CRS Report RL33534, *China's Economic Conditions*, by Wayne M. Morrison. For general information on U.S.-China ties, see CRS Report R41108, *U.S.-China Relations: Policy Issues*, by Thomas Lum.

<sup>2</sup> The United States suspended China's MFN status in 1951, which cut off most bilateral trade. China's MFN status was conditionally restored in 1980 under the provisions set forth under Title IV of the 1974 Trade Act, as amended (including the Jackson-Vanik freedom-of-emigration provisions). China's MFN status (which was redesignated under U.S. trade law as normal trade relations status, or NTR) was renewed on an annual basis until January 2002, when permanent NTR was extended to China (after it joined the WTO in December 2001).

<sup>3</sup> Estimates for 2010 used in this report are based on actual trade data for January-October 2010.

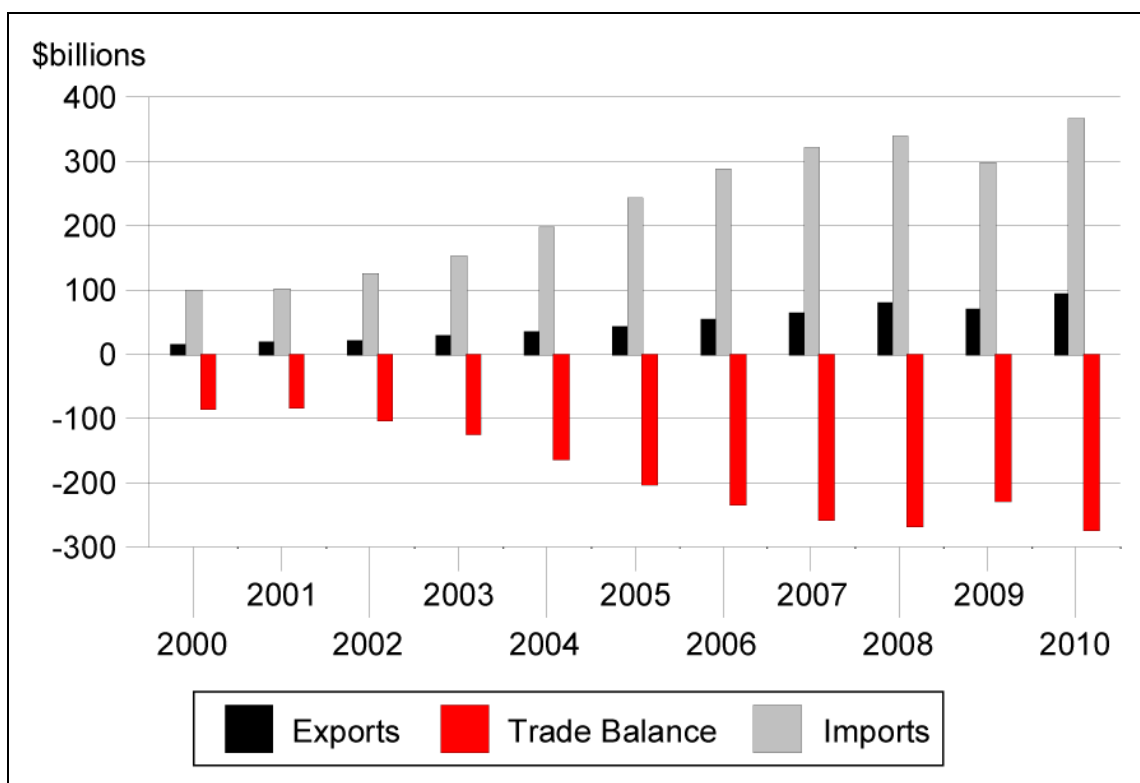
**Table I. U.S. Merchandise Trade with China:  
1980-2010**  
(\$ billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0.0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3
2008	71.5	337.8	-266.3
2009	69.6	296.4	-226.8
2010 estimate	93.3	365.8	-272.5

**Source:** U.S. International Trade Commission DataWeb.

**Note:** 2010 estimate based on actual data for January-October 2010.

**Figure I. U.S. Trade With China: 2000-2010**



**Source:** U. S. International Trade Commission DataWeb.

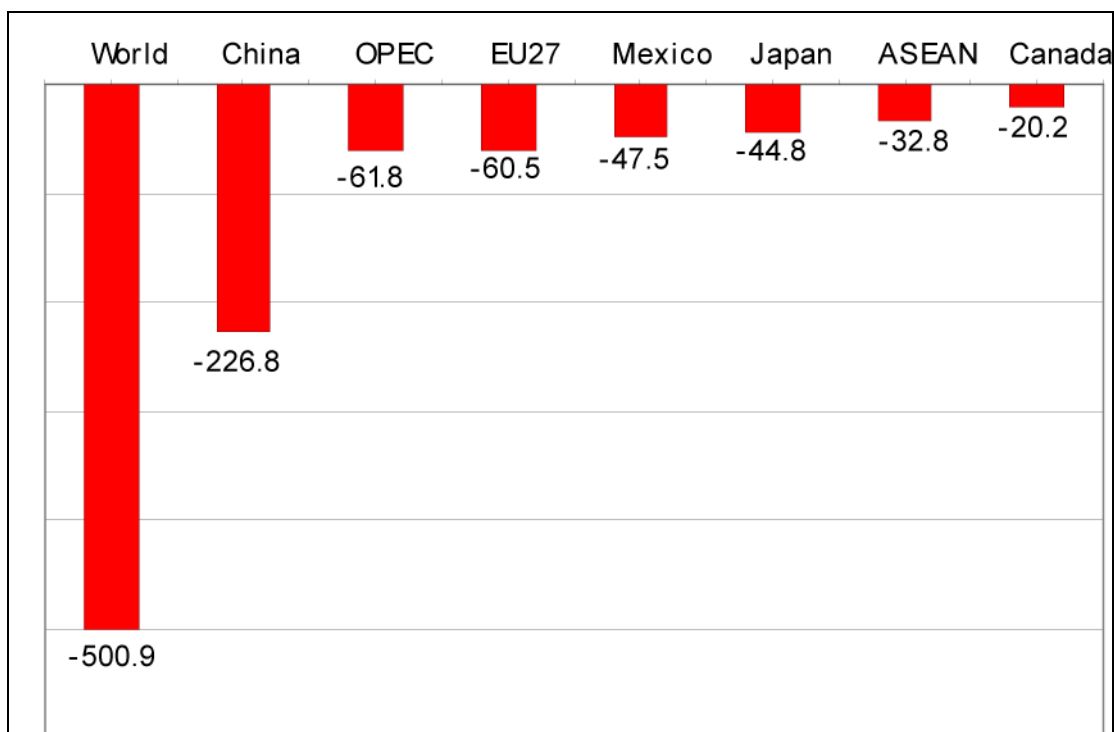
**Note:** Data for 2010 estimated, based on January-October 2010.

**Table 2. U.S. Merchandise Trade Balances with Major Trading Partners: 2008-2009**  
(\$ billions)

Country or Trading Group	2008	2009
World	-800.0	-500.9
<b>China</b>	<b>-266.3</b>	<b>-226.8</b>
The Organization of Petroleum Exporting Countries (OPEC)	-165.7	-61.8
European Union (EU27)	-93.4	-60.5
Mexico	-64.4	-47.5
Japan	-72.7	-44.8
Association of Southeast Asian Nations (ASEAN)	-42.0	-38.2
Canada	-74.6	-20.2

**Source:** U.S. International Trade Commission DataWeb.

**Figure 2. U.S. Trade Balances with the World and Various Trading Partners: 2009**  
(\$ billions)



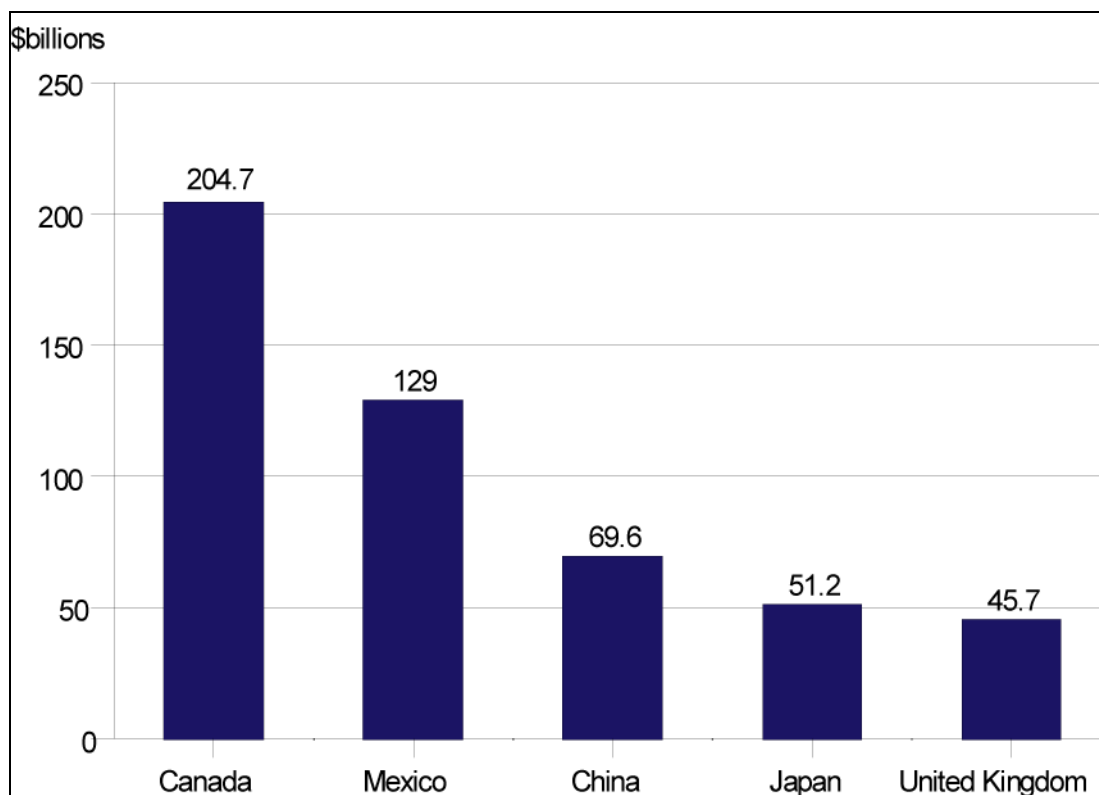
**Source:** U.S. International Trade Commission DataWeb.



## U.S. Merchandise Exports to China

U.S. merchandise exports to China in 2009 were \$69.6 billion (down 2.6% from 2008 levels).<sup>4</sup> During the first 10 months of 2010, U.S. merchandise exports to China were up 34.1% over the same period in 2009, and are projected to have reached about \$93 billion during the full year in 2010.<sup>5</sup> China has been the third-largest U.S. merchandise export market since 2007, when it overtook Japan (see **Figure 3**). U.S. exports to China in 2009 accounted for 6.6% of total U.S. exports, compared to 1.6% in 1989. The top five U.S. exports to China in 2009 were oilseeds and grains, waste and scrap, semiconductors and electronic components, aircraft and parts, and resins and synthetic rubber and fibers (see **Table 3**).<sup>6</sup>

**Figure 3. Major U.S. Export Markets: 2009**



**Source:** U.S. International Trade Commission DataWeb.

Over the past few years, China has been among the fastest-growing U.S. export markets, as can be seen in **Table 4**. Although U.S. exports to China in 2009 declined because of the global

<sup>4</sup> In addition U.S. exports of private services to China totaled \$16 billion in 2009.

<sup>5</sup> Some U.S. analysts have expressed concern over the composition of U.S. exports to China, noting that much of it consists of scrap products and components, as opposed to high value assembled products. They contend that restrictive Chinese trade practices and industrial policies have a major impact on the composition of U.S. exports to China. Chinese officials counter that U.S. export controls on high technology significantly reduce potential U.S. exports to China.

<sup>6</sup> China was the second-largest export market for U.S. agricultural, fish, and forest products in 2009 (at \$14.3 billion); major product categories included soybeans, cotton, and hides and skins. (Source: U.S. Department of Agriculture, Foreign Agricultural Service, Global Agricultural Trade System).

economic slowdown, they fell at a smaller rate (-2.6%) than those to any other top 10 U.S. export market and much less than the decline in overall U.S. exports (-18.7%). From 2001 to 2009, U.S. exports to China increased by about 263%, which was significantly faster than U.S. exports to other major U.S. exports markets.

**Table 3. Major U.S. Exports to China: 2005-2009**

(\$ millions and percent change)

NAIC Number and Description	2005	2006	2007	2008	2009	Percent Change 2008-2009 (%)
1111 Oilseeds and grains	2,339	2,593	4,145	7,316	9,376	28.1%
9100 Waste and scrap	3,670	6,071	7,331	7,562	7,142	-5.5%
3344 Semiconductors and other electronic components	4,015	6,830	7,435	7,475	6,042	-19.2%
3364 Aerospace products and parts (mainly aircraft)	4,535	6,309	7,447	5,471	5,344	-2.3%
3252 Resin, synthetic rubber, and artificial & synthetic fibers & filament	2,127	2,548	3,290	3,524	4,036	14.5%

**Source:** USITC DataWeb. Top five U.S. exports to China in 2009.

**Note:** North American Industry Classification (NAIC) system, 4-digit level.

**Table 4. U.S. Merchandise Exports to Major Trading Partners: 2001 and 2009**

(\$ billions and percent change)

	2001	2009	% Change from 2008-2009	% Change from 2001-2009
Canada	163.7	204.7	-21.5	25.0
Mexico	101.5	129.0	-14.9	27.1
<b>China</b>	<b>19.2</b>	<b>69.6</b>	<b>-2.6</b>	<b>262.5</b>
Japan	57.6	51.2	-23.1	-11.1
United Kingdom	40.8	45.7	-15.0	12.0
Germany	30.1	43.2	-20.9	43.5
Netherlands	19.5	32.3	-19.6	65.6
South Korea	22.2	28.6	-17.7	28.8
France	19.9	26.5	-9.1	33.2
Brazil	15.9	26.2	-20.5	66.7
World	731.0	1,056.9	-18.7	44.6

**Source:** U.S. International Trade Commission DataWeb.

**Note:** Ranked by top ten U.S. export markets in 2009.

Many trade analysts argue that China could prove to be a much more significant market for U.S. exports in the future. China is one of the world's fastest-growing economies, and rapid economic growth is likely to continue in the near future, provided that economic reforms are continued. China's goals of modernizing its infrastructure, upgrading its industries, and improving rural living standards could generate substantial demand for foreign goods and services. Finally,

economic growth has substantially improved the purchasing power of Chinese citizens, especially those living in urban areas along the east coast of China. China's growing economy, large foreign exchange reserves (at over \$2.5 trillion as of June 2010), and large population of over 1.3 billion people make it a potentially enormous market. To illustrate:

- China currently has the world's largest mobile phone network and one of the fastest-growing markets, with an estimated 844 million mobile phone subscribers in 2010, up from 87 million subscribers in 2000.<sup>7</sup>
- Boeing Corporation predicts that over the next 20 years (2009-2028), China will be the largest market for commercial air travel outside the United States and that it will buy 3,770 new aircraft (tripling the size of its current fleet), valued at \$400 billion.<sup>8</sup>
- It is estimated that in 2008, China replaced the United States as the world's largest Internet user. In 2009, China had an estimated 360 million Internet users versus 228 million in the United States.<sup>9</sup> Yet, the percentage of the Chinese population using the Internet is small relative to the United States: 19% versus 73%, respectively.
- The Chinese government projects that by the year 2020, there will be 140 million cars in China (seven times the current level), and that the number of cars sold annually will rise from 8.63 million units (2008) to 20.7 million units in 2020. According to some estimates, China is now the world's largest market for new cars. In 2009, General Motors (GM) and Ford reportedly sold 1.8 million (up 67% over 2008 levels) and 441,000 vehicles (up 44%), respectively, in China.<sup>10</sup> Despite the current global economic crisis, China auto sales during 2009 were up 44% over the previous year (to 13.6 million units), due largely to Chinese government tax subsidies and incentives.

## Major U.S. Imports from China

China was the largest source of U.S. imports in 2009 at \$296 billion (down from \$338 billion in 2008), which was 19.0% of total U.S. imports (compared to 6.5% of total in 1996). During the first 10 months of 2010, U.S. imports from China increased by 23.4% over the same period in 2009, and were projected to have reached \$366 billion for the full year in 2010. The importance (ranking) of China as a source of U.S. imports has risen dramatically, from eighth-largest in 1990, to fourth in 2000, to second in 2004-2006, to first in 2007-2009. The top five U.S. imports from China in 2009 were computers and parts, miscellaneous manufactured articles (such as toys, games, etc.), communications equipment, apparel, and audio and video equipment (see **Table 5**). In 2009, China was the third-largest source of U.S. imports of U.S. agricultural, fish, and forest

<sup>7</sup> In comparison, the United States has 287 million mobile phone subscribers. Source: European Information Technology Observatory - ICT market reports, August 2010, [http://www.eito.com/pressinformation\\_20100811.htm](http://www.eito.com/pressinformation_20100811.htm).

<sup>8</sup> Boeing Corporation, *Current Market Outlook, 2009-2028*, September 2009, p. 10.

<sup>9</sup> Internet World Stats, at <http://www.internetworldstats.com/top20.htm>.

<sup>10</sup> According to GM's website, it operates seven joint ventures and two wholly owned foreign enterprises and has more than 20,000 employees in China.

products, at \$7.2 billion; major product categories included forest products, seafood, and processed fruit and vegetables.<sup>11</sup>

**Table 5. Major U.S. Imports From China: 2005-2009**

(\$ millions and percent change)

NAIC Number and Description	2005	2006	2007	2008	2009	Percent Change 2008–2009
3341 Computer equipment	35,467	40,046	44,462	45,820	44,818	-2.2
3399 Misc. manufactured commodities	26,449	28,888	34,827	35,835	30,668	-14.4
3342 Communications equipment	14,121	17,977	23,192	26,618	26,362	-1.0
3152 Apparel	16,362	19,228	22,955	22,583	22,669	0.4
3343 Audio and video equipment	15,287	18,789	19,075	19,715	18,243	-7.4

**Source:** U.S. International Trade Commission DataWeb.

**Note:** North American Industry Classification system, 4-digit level.

Throughout the 1980s and 1990s, nearly all of U.S. imports from China were low-value, labor-intensive products, such as toys and games, consumer electronic products, footwear, and textiles and apparel. However, over the past few years, an increasing proportion of U.S. imports from China have been comprised of more technologically advanced products. For example, according to the U.S. Census Bureau, U.S. imports of advanced technology products (ATP) from China in 2009 totaled \$89.7 billion. ATP products accounted for 30.3% of total U.S. imports from China, compared with 19.2% (\$29.3 billion) in 2003.<sup>12</sup> In addition, China in 2009 accounted for 29.8% of total U.S. ATP imports, compared with 14.1% in 2003.

U.S. exports of ATP to China in 2009 were \$17.2 billion; these accounted for 24.7% of total U.S. exports to China and 7.0% of U.S. global ATP exports. The United States ran a \$72.5 billion deficit in its ATP trade with China in 2009. Some see the large and growing U.S. trade deficit in ATP with China as source of concern, contending that it signifies the growing international competitiveness of China in high technology. Others dispute this, noting that a large share of the ATP imports from China are in fact relatively low-end technology products and parts, such as notebook computers.

## China as a Major Center for Global Supply Chains

Many analysts contend that the sharp increase in U.S. imports from China (and hence the growing bilateral trade imbalance) is largely the result of movement in production facilities from other

<sup>11</sup> U.S. Department of Agriculture, Foreign Agricultural Service, Global Agricultural Trade System.

<sup>12</sup> Census broadly defines ATP as products whose technology is from a recognized high technology field and represent leading edge technology in that field. Broad product categories include biotechnology, life sciences, opto-electronics, information and communications, electronics, flexible manufacturing (e.g., robots), advanced materials, aerospace, weapons, and nuclear technology.

(primarily Asian) countries to China. That is, various products that used to be made in such places as Japan, Taiwan, Hong Kong, etc., and then exported to the United States are now being made in China (in many cases, by foreign firms in China) and exported to the United States. To illustrate, in 1996, 38.8% of total U.S. imports were from Asia; U.S. imports from China were 6.5% of total U.S. imports. In 2009, the share of U.S. imports from Asia actually declined from 1996 levels to 37.6%; however, the share of total U.S. imports from China rose to 19%. Another illustration of the shift in production can be seen in the case of computer imports, which currently are the largest category of imports from China (on an NAIC basis, 4-digit level). **Table 6** lists U.S. imports of computer equipment and parts from 2000-2009. In 2000, Japan was the largest foreign supplier of U.S. computer equipment (with a 19.6% share of total shipments), while China ranked fourth (with a 12.1% share). In just nine years, Japan's ranking fell to fourth, the value of its shipments dropped by 61%, and its share of U.S. computer imports declined to 6.7% (2009). China was by far the largest foreign supplier of computer equipment in 2009 with a 58% share of total U.S. imports, compared to 12% in 2000 (see **Figure 4**). While U.S. imports of computer equipment from China from 2000-2009 rose by 440%, the total value of U.S. computer imports worldwide rose by only 14%. Many analysts contend that a large share of the increase in Chinese computer production and exports has come from foreign computer companies that have moved manufacturing facilities to China. For example, Taiwan, one of the world's leaders in sales of information technology, produces over 90% its information hardware equipment (such as computers) in China.<sup>13</sup>

**Table 6. Major Foreign Suppliers of U.S. Computer Equipment Imports: 2000-2009**  
(\$ billions and percent change)

	2000	2002	2004	2006	2008	2009	2000-2009 % change
Total	68.5	62.3	73.9	83.8	85.4	77.9	13.7
<b>China</b>	<b>8.3</b>	<b>12.0</b>	<b>29.5</b>	<b>40.0</b>	<b>45.8</b>	<b>44.8</b>	<b>440.0</b>
Mexico	6.9	7.9	7.4	6.6	6.2	7.6	10.1
Malaysia	4.9	7.1	8.7	11.1	9.0	5.6	14.3
Japan	13.4	8.1	6.3	6.3	6.6	5.2	-61.2
Singapore	8.7	7.1	6.6	5.6	4.0	3.5	-59.8

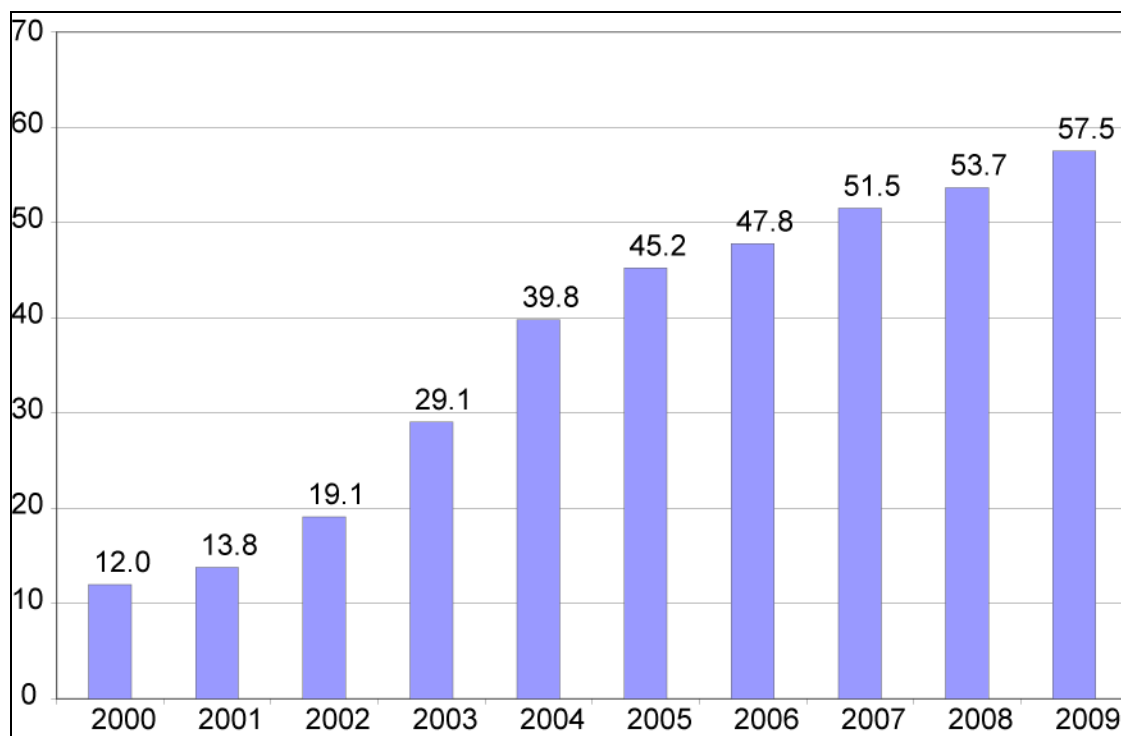
**Source:** U.S. International Trade Commission Trade DataWeb.

**Note:** Ranked according to top five suppliers in 2009.

<sup>13</sup> China's accession to the WTO (with the reduction of trade and investment barriers) appears to have been a major factor behind the migration of computer production from other countries to China.

**Figure 4. Share of U.S. Computer Imports from China: 2000-2009**

(percent)

**Source:** U.S. International Trade Commission DataWeb.

### Global Supply Chains, China, and the Apple iPod: Who Benefits?

Many U.S. companies sign contracts with Taiwanese firms to have their products manufactured (mainly in China), and then shipped to the United States where they are sold by U.S. firms under their own brand name. In many instances, the level of value-added that occurs in China (often it simply involves assemblage) can be quite small relative to the overall cost/price of the final product. One study by researchers at the University of California looked at the production of a 2005 Apple 30 gigabyte video iPod, which is made in China by Foxconn, a Taiwanese company, using parts produced globally (mainly in Asia). The study estimated that it cost about \$144 to make each iPod unit. Of this amount, only about \$4, or 2.8% of the total cost, was attributable to the Chinese workers who assembled it; the rest of the costs were attributable to the numerous firms involved in making the parts (for example, Japanese firms provided the highest-value components—the hard drive and the display).<sup>14</sup> From a trade aspect, U.S. trade data would have recorded the full value of each iPod unit imported from China at \$144 (excluding shipping costs) as originating from China, even though the value added in China was quite small. The retail price of the iPod sold in the United States was \$299, meaning that there was a mark-up of about \$155 per unit, which was attributable to transportation costs, retail and distributor margins, and Apple's profits. The study estimated that Apple earned at least \$80 on each unit it sold in its stores, making it the single largest beneficiary (in terms of gross profit) of the sale of the iPod. The study concluded that Apple's innovation in developing and engineering the iPod and its ability to source most of its production to low-cost countries, such as China, has helped enable it to become a highly competitive and profitable firm (as well as a source for high-paying jobs in the United States). The iPod example illustrates that the rapidly changing nature of global supply chains has made it increasing difficult to interpret the implications of U.S. trade data. Such data may show where products are being imported from, but they often fail to reflect who benefits from that trade. Chinese trade data indicate that over 50% of its exports are generated by foreign-invested firms in China. Thus, in many instances, U.S. imports from China are really imports from many countries.

### U.S.-China Investment Ties<sup>15</sup>

Investment plays a major role in U.S.-China commercial ties.<sup>16</sup> China's investment in U.S. assets can be broken down into two categories: holdings of U.S. securities and foreign direct investment (FDI). A significant share of China's investment in the United States is comprised of U.S. securities, while FDI constitutes the bulk of U.S. investment in China. The Treasury Department defines foreign holdings of U.S. securities as "U.S. securities owned by foreign residents (including banks and other institutions) except where the owner has a direct investment relationship with the U.S. issuer of the securities." These include long-term (LT) U.S. Treasury securities, LT U.S. government agency securities,<sup>17</sup> LT corporate securities (some of which are asset-backed), equities (such as stocks), and short-term (ST) debt.<sup>18</sup> The U.S. Bureau of Economic Analysis (BEA) defines FDI (in the United States) as "the ownership or control, directly or indirectly, by one foreign resident of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or the equivalent interest in an unincorporated U.S. business

<sup>14</sup> Communications of the ACM, *Who Captures Value in a Global Innovation Network? The Case of Apple's iPod*, March 2009.

<sup>15</sup> U.S. data on FDI flows to and from China differ sharply from Chinese data on FDI flows to and from the United States. This section uses U.S. data only.

<sup>16</sup> Investment is often a major factor behind trade flows. Firms that invest overseas often import machinery, parts, and other inputs from the parent company to manufacture products for export or sale locally. Other such invested overseas firms may produce inputs and ship them to their parent company for final production.

<sup>17</sup> Agency securities include both federal agencies and government-sponsored enterprises created by Congress (e.g., Fannie Mae and Freddie Mac) to provide credit to key sectors of the economy. Some of these securities are backed by assets (such as home mortgages).

<sup>18</sup> LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more than one year. ST debt includes U.S. Treasury securities, agency securities, and corporate securities with a maturity date of less than one year.

enterprise.”<sup>19</sup> BEA classifies FDI flows according to broad industrial sections, including mining; utilities; manufacturing (broken down into nine subsectors<sup>20</sup>); wholesale trade; information; depository institutions; finance (excluding depository institutions); professional, scientific, and technical services; non-bank holding companies; and other industries.

## China's Holdings of U.S. Securities<sup>21</sup>

The Treasury Department performs annual surveys of foreign holders of short-term (less than one year) and long-term (one year or longer) U.S. securities for the period ending in June. The Treasury Department April 2010 report estimates that China's total holdings of U.S. securities at the end of June 2009 were \$1.5 trillion, compared to \$1.2 trillion in June 2008, an increase of 21.5% (see **Figure 5**).<sup>22</sup> From June 2002 to June 2009, China's holdings of U.S. securities as a share of total foreign holdings of U.S. securities rose from 3.9% to 15.2%, increasing its ranking of major foreign holders of U.S. securities from fifth to first. Over this period, China's holdings grew by nearly \$1.3 trillion (or 707%), by far the largest increase in U.S. securities holdings of any other country.<sup>23</sup> These massive holdings are largely the result of China's currency policy (discussed below).

The largest type of U.S. securities held by China are short-term and long-term U.S. Treasury securities, which are used to finance U.S. federal budget deficits. Data for foreign holdings of these type of securities are reported on a monthly basis. China's holdings of U.S. Treasury securities rose from \$118 billion (or 9.6% of total foreign holdings) at the end of 2002 to \$895 billion in 2009 year-end (24.2% of total) (see **Table 7**).<sup>24</sup> China's holdings increased to about \$907 billion as of October 2010, but their share relative to total foreign holdings dropped to 21.0%. China has been the largest foreign holder of U.S. Treasuries since September 2008.<sup>25</sup>

<sup>19</sup> The 10% ownership share is the threshold considered to represent an effective voice or lasting influence in the management of an enterprise. See BEA, *International Economic Accounts, BEA Series Definitions*, available at <http://www.bea.gov/international>.

<sup>20</sup> These sectors include food; chemicals; primary and fabricated metals; machinery; computers and electronic products; electrical equipment, appliances and components; transportation equipment, and other manufacturing.

<sup>21</sup> For additional information on this issue, see CRS Report RL34314, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, by Wayne M. Morrison and Marc Labonte.

<sup>22</sup> U.S. Treasury Department, *Preliminary Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2009*, April 2010.

<sup>23</sup> U.S. Treasury Department, *Report on Foreign Portfolio Holdings of U.S. Securities*, various editions. Note: 2002 was the first year in which surveys listed data as of June. Prior to that, survey data were listed as of March or December.

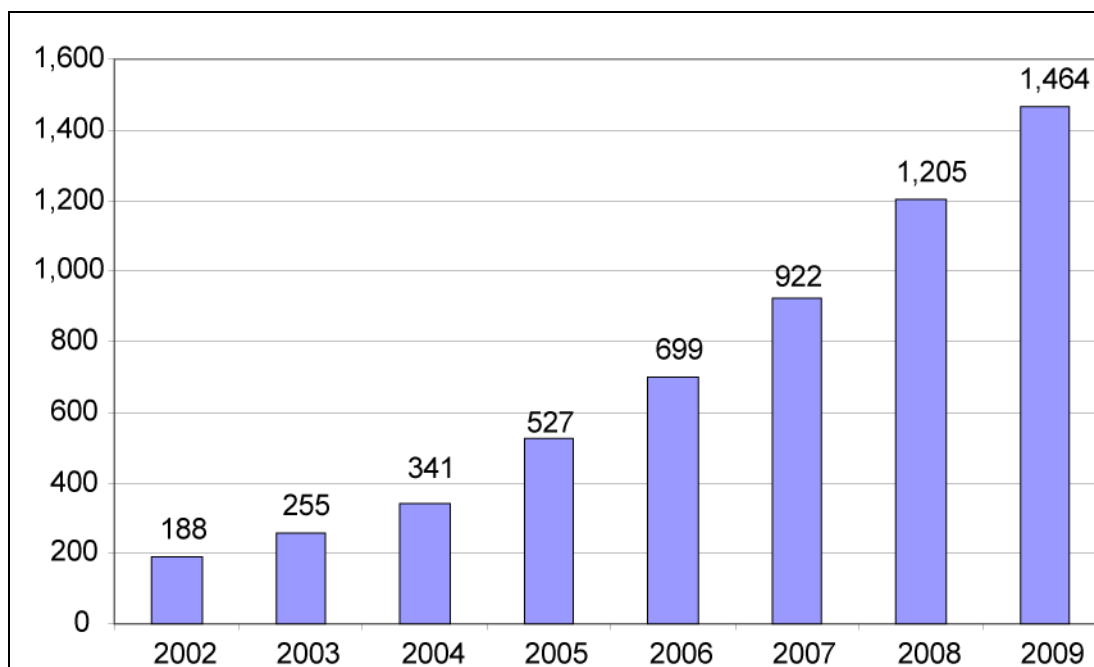
<sup>24</sup> U.S. Treasury Department, *Major Foreign Holders of U.S. Treasury Securities*, July 16, 2010. Note: the Treasury Department often revises its estimates of foreign holdings for a given year, but not for previous years. Thus, comparisons of multi-year data should be interpreted with caution.

<sup>25</sup> The Treasury Department attempts to determine the country of origin of the buyer of the Treasury securities. This can prove challenging because buyers often purchase them through financial institutions in other countries. It is thought that China buys a significant share of its U.S. Treasury securities via the United Kingdom, Hong Kong, and elsewhere. Thus, U.S. data on foreign holders of U.S. Treasury securities might understate China's actual level of holdings.



**Figure 5. China's Holdings of U.S. Securities: June 2002-June 2009**

(\$ billions)

**Source:** U.S. Department of the Treasury.**Notes:** U.S. securities include short-term and long-term debt, including Treasury securities, U.S. government agency securities, U.S. corporate securities, and U.S. equities.**Table 7. China's Holdings of U.S. Treasury Securities: 2003-2009 and October 2010**

(\$ billions and as a percent of total foreign holdings)

	2003	2004	2005	2006	2007	2008	2009	Oct. 2010
China's Holdings (\$ billions)	159.0	222.9	310.0	396.9	477.6	727.4	894.8	906.8
China's Holdings as a Percent of Total Foreign Holdings	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	24.2%	21.0%

**Source:** U.S. Treasury Department.**Notes:** Data based on periodical surveys by the Treasury Department, which often revises estimates for the previous year but not for all years and thus should be interpreted with caution. Annual data are year-end values.

Many U.S. policymakers have raised concern over China's large and growing holdings of U.S. securities, stating that, while such purchases have contributed to the ability of the United States to meet its investment needs and have helped fund the growing U.S. federal budget deficit (thus helping to keep real U.S. interest rates low), they could give China increased leverage over the United States on major bilateral political and economic issues.<sup>26</sup> In the 111<sup>th</sup> Congress, bills were introduced that sought to increase the transparency regarding U.S. debt instruments held by foreign governments (including China—the largest foreign holder) to better assess the risks such holdings may have to the United States. Others counter that, given China's economic dependency on a stable and growing U.S. economy, and its substantial holdings of U.S. securities, any attempt to try to “dump” a large share of those holdings would likely damage both the U.S. and Chinese economies; it would also likely reduce the value of China's remaining holdings of U.S. dollar assets, and, thus, is not a feasible option for China.

Over the past year or so, Chinese officials have expressed concern over the “safety” of their large holdings of U.S. debt. They worry that growing U.S. government debt will eventually spark inflation in the United States, resulting in a sharp depreciation of the dollar. This would diminish the value of China's dollar asset holdings.<sup>27</sup> Several Chinese officials have publicly called for replacing the dollar as the world's major reserve currency with some other currency arrangement, such as through the International Monetary Fund's special drawing rights system. Most mainstream economists do not think this would be a feasible alternative in the short run.

## **Bilateral FDI Flows**

China's FDI in the United States is quite small relative to its holdings of U.S. securities: \$1.2 billion (cumulative at the end of 2008) versus nearly \$1.5 trillion (as of June 2009), respectively.<sup>28</sup> In 2008, China ranked as the 30<sup>th</sup>-largest source of FDI in the United States.<sup>29</sup> Cumulative U.S. FDI in China in 2008 was \$45.6 billion (roughly the size of cumulative U.S. FDI in Brazil and half that in Mexico), making it the 17<sup>th</sup>-largest overall destination of U.S. FDI. In 2008, U.S. FDI in China was \$15.7 billion, while China's FDI in the United States was \$368 million (see **Table 8**).

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<sup>26</sup> Some policymakers argue, for example, that China could threaten to sell off a large share of its dollar holdings, which could have a number of significant consequences for the U.S. economy.

<sup>27</sup> See *China View*, “U.S. stimulus-related debt could hurt investors, China warns,” February 18, 2009.

<sup>28</sup> All BEA data is on a historical-cost, or book value, basis.

<sup>29</sup> For information on Chinese data on FDI flows with the United States (and other countries), see CRS Report RL33534, *China's Economic Conditions*, by Wayne M. Morrison.

**Table 8. U.S. and Chinese Bilateral FDI Flows, Annual and Cumulative: 2002-2008**  
(\$ millions)

	2002	2003	2004	2005	2006	2007	2008	Cumulative: all years through 2008
China's FDI in the U.S.	-120	-62	150	146	315	137	368	1,235
U.S. FDI in China	875	1,273	4,499	1,955	4,226	5,331	15,726	45,695

**Source:** U.S. Bureau of Economic Analysis.

**Notes:** Cumulative data is on a historical-cost basis. U.S. and Chinese data on bilateral FDI flows differ significantly.

The United States and China are currently negotiating a bilateral investment treaty (BIT) with the goal of expanding bilateral investment opportunities. U.S. negotiators hope such a treaty would improve the investment climate for U.S. firms in China by enhancing legal protections and dispute resolution procedures, and by obtaining a commitment from the Chinese government that it would treat U.S. investors no less favorably than Chinese investors. The Chinese side appears to want to boost the ability of its firms to invest in the United States, especially with regard to mergers and acquisitions; they have complained that the political climate in the United States discourages such investment. Some U.S. groups have expressed reservations concerning a China-U.S. BIT, arguing that it would encourage U.S. firms to relocate to China.<sup>30</sup>

## Major U.S.-China Trade Issues

Although China's economic reforms and rapid economic growth have expanded U.S.-China commercial relations in recent years, tensions have arisen over a wide variety of issues. Major U.S. concerns have included China's resistance to adopting a market-based currency; its mixed record on implementing its obligations in the WTO, including its failure to provide adequate protection of U.S. intellectual property rights (IPR); its use of industrial policies to promote various domestic industries, including discriminatory government procurement policies; and the health and safety of certain imported Chinese products, such as drywall.

### China's Currency Policy<sup>31</sup>

Unlike most advanced economies (such as the United States), China does not maintain a market-based floating exchange rate. Between 1994 and July 2005, China pegged its currency, the renminbi (RMB) or yuan, to the U.S. dollar at about 8.28 yuan to the dollar.<sup>32</sup> In July 2005, China appreciated the RMB to the dollar by 2.1% and moved to a "managed float," based on a basket of

<sup>30</sup> *Inside U.S.-China Trade*, April 28, 2010.

<sup>31</sup> For additional information on this issue, see CRS Report RS21625, *China's Currency: An Analysis of the Economic Issues*, by Wayne M. Morrison and Marc Labonte.

<sup>32</sup> The official name of China's currency is the renminbi, which is denominated in units of yuan.

major foreign currencies, including the U.S. dollar. In order to maintain a target rate of exchange with the dollar (and other currencies), the Chinese government has maintained restrictions and controls over capital transactions and has made large-scale purchases of U.S. dollars (and dollar assets).<sup>33</sup> According to the Bank of China, from July 2005 to July 2009, the dollar-yuan exchange rate went from 8.27 to 6.83 yuan per dollar, an appreciation of 21.1%.<sup>34</sup> However, once the effects of the global financial crisis became apparent, the Chinese government halted its appreciation of the RMB and subsequently kept the yuan/dollar exchange rate relatively constant at 6.83 from July 2009 to June 2010 in order to help limit the impact of the sharp decline in global demand for Chinese products.

Many U.S. policymakers, labor groups, and business representatives of import-sensitive industries have charged that, despite minor reforms, the Chinese government continues to manipulate its currency in order to keep the value of its currency artificially low against the dollar (with estimates of undervaluation ranging from 15% to 50%). They claim that this policy constitutes a de facto subsidy for Chinese exports to the United States, and acts as a de facto tariff on Chinese imported U.S. goods. They complain that this policy has particularly hurt several U.S. manufacturing sectors that are forced to compete against low-cost Chinese products, and has led to the loss of hundreds of thousands of U.S. jobs. Critics further charge that China's currency policy has been a major factor in the size and growth of the U.S. trade deficit with China. Some members of Congress contend that, given the current high rate of unemployment in the United States, Chinese "currency manipulation" can no longer be tolerated.

Chinese officials have insisted that the current currency policy is not meant to favor exports over imports, but instead to foster domestic economic stability.<sup>35</sup> They have expressed concern that abandoning the currency policy, especially given the current state of the global economy, could further weaken its export industries and cause wide-scale layoffs. Chinese officials view economic stability as critical to sustaining political stability. However, on June 19, 2010, the Chinese central bank, the People's Bank of China (PBC) stated that, based on current economic conditions, it had decided to "proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility." It ruled out any large one-time revaluations, stating "it is important to avoid any sharp and massive fluctuations of the RMB exchange rate," in part so that Chinese corporations could more easily adjust (such as through upgrading) to an appreciation of the currency. Many observers contend the timing of the RMB announcement was intended in part to prevent China's currency policy from being a central focus of the G-20 summit in Toronto from June 26-27, 2010, and possibly to head off threatened congressional action over the issue. From June 19, 2010 to December 28, 2010, the RMB appreciated by 3.1% against the dollar, a pace that has been criticized by U.S. officials as far too slow, especially given China's rising trade surplus in 2010.

Numerous bills have been introduced in Congress over the past few years that would seek to induce China to reform its currency policy or would attempt to address the perceived effects that

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<sup>33</sup> Much of China's trade is believed to be in U.S. dollars (e.g., exporters are often paid in dollars). The central government requires firms to exchange most of their dollars for RMB.

<sup>34</sup> Calculated from Bank of China data using the official middle rate.

<sup>35</sup> A fixed exchange rate is a relatively common practice among developing countries, especially those that want to attract foreign investment and expand exports. A constant exchange rate, such as one tied to the U.S. dollar, attempts to signal foreign investors that the value of their investments will not be affected by the type of large swings in exchange rates that can occur under a floating exchange rate regime. Given the current size of China's economy and trade flows, most economists question whether the continuation of China's currency policy is appropriate.

policy has on the U.S. economy. For example, one bill in the 108<sup>th</sup> Congress (S. 1586) would have imposed an additional duty of 27.5% on imported Chinese products unless China appreciated its currency to near market levels. In the 111<sup>th</sup> Congress, the House passed an amended version of H.R. 2378, which would have made certain misaligned currencies (such as the RMB) actionable under U.S. countervailing duty cases on foreign government export subsidies; the Senate did not take up the bill.

## **China's Obligations in the World Trade Organization**

Negotiations for China's accession to the General Agreement on Tariffs and Trade (GATT) and its successor organization, the WTO, began in 1986 and took over 15 years to complete. During the WTO negotiations, Chinese officials insisted that China was a developing country and should be allowed to enter under fairly lenient terms. The United States insisted that China could enter the WTO only if it substantially liberalized its trade regime. In the end, a compromise was reached that required China to make immediate and extensive reductions in various trade and investment barriers, while allowing it to maintain some level of protection (or a transitional period of protection) for certain sensitive sectors. China's WTO membership was formally approved at the WTO Ministerial Conference in Doha, Qatar, on November 10, 2001. Taiwan's WTO membership was approved the next day. On November 11, 2001, China notified the WTO that it had formally ratified the WTO agreements, and on December 11, 2001, it formally joined the WTO.<sup>36</sup> Many U.S. policymakers at the time maintained that China's WTO membership would encourage it to deepen market reforms, promote the rule of law, reduce the government's role in the economy, and further integrate it into the world economy. As a result, it was hoped, China would become a more reliable and stable U.S. partner.

Under the WTO accession agreement, China agreed to

- Reduce the average tariff for industrial goods and agriculture products to 8.9% and 15%, respectively (with most cuts made by 2004 and all cuts completed by 2010).
- Limit subsidies for agricultural production to 8.5% of the value of farm output and eliminate export subsidies on agricultural exports.
- Within three years of accession, grant full trade and distribution rights to foreign enterprises (with some exceptions, such as for certain agricultural products, minerals, and fuels).
- Provide non-discriminatory treatment to all WTO members. Foreign firms in China would be treated no less favorably than Chinese firms for trade purposes. End discriminatory trade policies against foreign invested firms in China, such as domestic content rules and technology transfer requirements.
- Implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement upon accession. (That agreement establishes basic standards on IPR protection and rules for enforcement.)

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<sup>36</sup> Following China's WTO accession, the United States, in January 2002, granted China permanent normal trade relations (PNTR) status (prior to that time, that status was on a conditional basis) to ensure that the United States and China had a formal trade relationship under the rules of the WTO.

- Fully open the banking system to foreign financial institutions within five years (by the end of 2006). Joint ventures in insurance and telecommunication would be permitted (with various degrees of foreign ownership allowed).

## WTO Implementation Issues

According to the U.S. Trade Representative's (USTR) office, China's record on implementing its WTO commitments has been mixed. On the one hand, China has generally implemented its tariff reductions on time. Its average overall tariff dropped from 15.6% in 2001 to 9.8% as of January 2010 (the tariff rate on industrial goods and agricultural products in 2010 was 8.9% and 15.2%, respectively) and a number of non-tariff measures have been eliminated. However, there have been several areas where China's implementation is considered to be incomplete. The USTR's ninth annual China WTO compliance report to Congress (issued in December 2010) identified several areas of concern, including:

- failure by the Chinese government to maintain an effective IPR enforcement regime (discussed below);
- industrial policies and national standards that attempt to promote Chinese firms (while discriminating against foreign firms);
- restrictions on trading and distribution rights (especially in regards to IPR-related products, such as movies, books, and music);
- discriminatory and unpredictable health and safety rules on imports (especially agricultural products); and
- burdensome regulations and restrictions on services, and failure to provide adequate transparency of trade laws and regulations.<sup>37</sup>

USTR officials contend that in the first years after China joined the WTO, it made noteworthy progress in adopting economic reforms that facilitated its transition toward a market economy and increased its openness to trade and FDI. However, beginning in 2006, progress toward further market liberalization appeared to slow. By 2008, U.S. government and business officials noted evidence of trends toward a more restrictive trade regime. A significant part of China's economy, including the banking system and state-owned enterprises (SOEs), is to a large extent, owned and controlled by central and local government entities—remnants of the old command economy that existed before reforms began in 1979. Although China agreed to make SOEs operate according to free market principles when it joined the WTO, U.S. officials contend that SOEs are still being subsidized, especially through the banking system. In addition, China is attempting to promote the development of several industries (such as autos, steel, telecommunications, aircraft, and high technology products) deemed by the government as important to China's future economic development and has implemented policies to promote and protect them. Some analysts contend that the global economic slowdown has induced the Chinese government to slow or even reverse its long-term movement toward market-based economic reforms. For example:

- In July 2010, China announced that it would reduce its export quota of rare earth elements (which are used in a wide variety of consumer electronics, green

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<sup>37</sup> USTR, *2010 Report to Congress on China's WTO Compliance*, December 2010, available at [http://www.ustr.gov/webfm\\_send/2460](http://www.ustr.gov/webfm_send/2460).

technology products, such as wind turbines, and a number of defense weapon systems) by 70% during the second half of 2010 over the previous year's level (or a 40% drop for the full year over 2009 levels).<sup>38</sup> In December 2010, China announced that quotas on rare earth would be cut further in 2011. China is estimated to produce 95% of the world's rare earth elements. Many analysts have raised concerns that the sharp cuts in China's rare earth exports could substantially raise prices of products that use rare earth elements. Some have argued that China's intention is to ensure that its own electronic and high technology industries have access to rare earth elements (and to boost their competitiveness by helping to keep prices low) and to induce foreign technology firms that use rare earth to move their production facilities to China. The USTR has indicated that it may bring a WTO case against China over its restrictions of rare earth elements.

- In March 2010, Google Inc. announced that it would redirect users of its Internet engine, Google.cn in China, to Google.com.hk in Hong Kong. Google said it was taking this step because of cyber attacks on its system believed to have originated inside China, the hacking of Gmail accounts of Chinese human rights activists, and because Google decided that it would no longer comply with the Chinese government's censorship requirements. On July 9, 2010, Google announced that the Chinese government had renewed its Internet Content Provider license, but stated it would provide limited services in China. A number of analysts contend that Chinese government Internet censorship and cyber attacks have gotten worse recently, and that such trends have undermined the business environment in China. Some groups have urged the U.S. government to file a WTO case against China over these activities.
- In November 2009, the Chinese government released a "Circular on Launching the 2009 National Indigenous Innovation Product Accreditation Work," requiring companies to file applications by December 2009 for their products to be considered for accreditation as "indigenous innovation products." The proposal would, in effect, extend preferential treatment for government procurement to domestic firms that developed and owned intellectual property in China projects (discussed in more detail below).
- In July 2009, the central government reportedly issued "buy China" regulations requiring that services, goods, and materials used for infrastructure projects funded by the government's November 2008 \$586 billion stimulus plan come from Chinese sources (unless such products are not available locally). In addition, the government's stimulus package, and policies to encourage extensive bank lending, are believed to have been largely targeted to assist SOEs, rather than private businesses.
- In February 2009, the Chinese government announced plans to provide financial support to 10 sectors, including autos, steel, shipbuilding, machinery, textiles, electronics and information (e.g., computers), light industry, petrochemicals, metals, and logistics. Financial support would include tax cuts and incentives, subsidies, directives to banks to provide financing, direct funds to support

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<sup>38</sup> For addition information on this issue, see CRS Report R41347, *Rare Earth Elements: The Global Supply Chain*, by Marc Humphries.

technology upgrades and the development of domestic brands, favorable government procurement policies, the extension of export credits, and funding to help firms invest overseas.

In several instances, the United States has brought trade dispute cases against China in the WTO to try to resolve trade issues that could not be resolved through bilateral negotiations, and China has brought cases against the United States as well.<sup>39</sup>

As of December 2010, the United States has initiated 11 WTO dispute resolution cases against China, several of which have been resolved or ruled upon.<sup>40</sup> These cases are summarized below.

### **Pending U.S. Cases Against China**

- On December 22, 2010, the USTR's office announced that it would bring a WTO case against China over a government program that extended subsidies to Chinese wind power equipment manufacturers that use parts and components made in China rather than foreign-made parts and components.
- On September 15, 2010, the USTR's office announced it was bringing a WTO case against China over its improper application of antidumping duties and countervailing duties on imports of grain oriented flat-rolled electrical steel from the United States.
- On September 15, 2010, the USTR's office announced it was bringing a WTO case against China over its discrimination against U.S. suppliers of electronic payment services.
- On June 23, 2009, the United States brought a case against China's export restrictions (such as export quotas and taxes) on raw materials (bauxite, coke, fluor spar, magnesium, manganese, silicon metal, silicon carbide, yellow phosphorus, and zinc). The United States charges that such policies are intended to lower prices for Chinese firms (steel, aluminum, and chemical sectors) in order to help them obtain an unfair competitive advantage. China claims that these restraints are intended to conserve the environment and exhaustible natural resources.

### **Resolved Cases and WTO Panel Rulings<sup>41</sup>**

- On December 19, 2008, the USTR filed a WTO case against China over its support for "Famous Chinese" brand programs, charging that such programs utilize various export subsidies (including cash grant rewards, preferential loans, research and development funding to develop new products, and payments to lower the cost of export credit insurance) at the central and local government level to promote the recognition and sale of Chinese brand products overseas. On

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<sup>39</sup> China has brought five cases against the United States. These have included challenges to U.S. applications of antidumping and countervailing measures, restrictions on imports of Chinese poultry, and U.S. safeguard measures restricting imports of Chinese tires.

<sup>40</sup> For an overview of the WTO dispute resolution process, see CRS Report RS20088, *Dispute Settlement in the World Trade Organization (WTO): An Overview*, by Jeanne J. Grimmett.

<sup>41</sup> Often cases are resolved through consultations before the case goes to a panel.



December 18, 2009, the USTR announced that China had agreed to eliminate these programs.

- On March 3, 2008, the USTR requested WTO dispute resolution consultations with China regarding its discriminatory treatment of U.S. suppliers of financial information services in China. On November 13, 2008, the USTR announced that China had agreed to eliminate discriminatory restrictions on how U.S. and other foreign suppliers of financial information services do business in China.
- On April 10, 2007, the USTR filed a WTO case against China, charging that it failed to comply with the TRIPS agreement (namely in terms of its enforcement of IPR laws). On January 26, 2009, the WTO ruled that many of China's IPR enforcement policies failed to fulfill its WTO obligations. On June 29, 2009, China announced that it would implement the WTO ruling by March 2010.
- On April 10, 2007, the USTR filed a WTO case against China, charging that it failed to provide sufficient market access to IPR-related products, namely in terms of trading rights and distribution services. In August 2009, the WTO ruled that many of China's regulations on trading rights and distribution that were raised by the U.S. case were WTO-inconsistent. China appealed the decision, but lost, and in February 2010 stated that it would implement the WTO panel decisions (see section on "Violations of U.S. Intellectual Property Rights").
- On February 5, 2007, the USTR announced it had requested WTO dispute consultations with China over government regulations that give illegal (WTO-inconsistent) import and export subsidies to various industries in China (such as steel, wood, and paper) that distort trade and discriminate against imports.<sup>42</sup> China's WTO accession agreement required it to immediately eliminate such subsidies. On November 29, 2007, China formally agreed to eliminate the subsidies in question by January 1, 2008.
- On March 30, 2006, the USTR initiated a WTO case against China for its use of discriminatory regulations on imported auto parts (which often applied the high tariff rate on finished autos to certain auto parts), stating that the purpose of these rules was to discourage domestic producers from using imported parts and to encourage foreign firms to move production to China. On February 13, 2008, a WTO panel ruled that China's discriminatory tariff policy was inconsistent with its WTO obligations (stating that the auto tariffs constituted an internal charge rather than ordinary customs duties, which violated WTO rules on national treatment). China appealed the decision, but a WTO Appellate Body largely upheld the WTO panel's decision.
- On March 18, 2004, the USTR announced it had filed a WTO dispute resolution case against China over its discriminatory tax treatment of imported semiconductors. The United States claimed that China applied a 17% value-added tax (VAT) rate on semiconductor chips that were designed and made outside China, but gave VAT rebates to domestic producers. Following consultations with the Chinese government, the USTR announced on July 8,

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<sup>42</sup> Some programs gave tax preferences, tariff exemptions, discounted loans, or other benefits to firms that met certain export performance requirements, while others gave tax breaks for purchasing Chinese-made equipment and accessories over imports.

2004, that China agreed to end its preferential tax policy by April 2005. However, the USTR has expressed concern over new forms of financial assistance given by the Chinese government to its domestic semiconductor industry.

## **Violations of U.S. Intellectual Property Rights**

The United States has pressed China to improve its IPR protection and enforcement regime since the late 1980s. In 1991, the United States (under a Section 301 case) threatened to impose \$1.5 billion in trade sanctions against China if it failed to strengthen its IPR laws. Although China later implemented a number of new IPR laws, it often failed to enforce them, which led the United States to once again threaten China with trade sanctions. The two sides reached a trade agreement in 1995, in which China pledged to take immediate steps to stem IPR piracy by cracking down on large-scale producers and distributors of pirated materials and prohibiting the export of pirated products, establishing mechanisms to ensure long-term enforcement of IPR laws and providing greater market access to U.S. IPR-related products.

Under the terms of its accession to the WTO in 2001, China agreed to immediately bring its IPR laws into compliance with the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement, which includes a commitment to establish an effective IPR enforcement regime. The USTR office has stated on a number of occasions that China has made great strides in improving its IPR protection regime, noting that it has passed several new IPR-related laws, closed or fined several assembly operations for illegal production lines, seized millions of illegal audio-visual products, curtailed exports of pirated products, expanded training of judges and law enforcement officials on IPR protection, and expanded legitimate licensing of film and music production in China. However, the USTR has indicated that much work needs to be done to improve China's IPR protection regime, especially in terms of deterrence.

Many business groups contend that poor IPR protection is one of the most significant obstacles for doing business in China. To illustrate:

- According to International Intellectual Property Alliance (IIPA), China has some of the highest piracy rates in the world, including 80% for business software and 90% for records and music (2009). Piracy in China for business software alone is estimated to cost U.S. firms \$3.1 billion in lost trade in 2009, which was larger than losses from any other foreign country.<sup>43</sup>
- The Business Software Alliance estimates that the commercial value of illegal software in China in 2009 was \$7.6 billion, up \$900 million over 2008 levels.
- The U.S. Customs and Border Protection (CBP) reported that China accounted for 79% (with a \$205 million domestic value) of pirated goods seized by the agency in FY2009.<sup>44</sup> CBP also reported that China accounted for more than 62% of the seizures of IPR infringing goods that posed a safety or security risk (such as fake pharmaceuticals).

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<sup>43</sup> Estimates made by the International Intellectual Property Rights Alliance.

<sup>44</sup> See CBP website at <http://www.CBP.gov>.

Piracy also has a number of negative effects on China's economy. For example:

- The Chinese government estimates that counterfeits constitute between 15% and 20% of all products made in China and are equivalent to about 8% of China's annual gross domestic product.
- A study by the Motion Picture Association of America estimated that China's domestic film industry lost about \$1.5 billion in revenue to piracy in 2005 (and that the combined losses of both foreign and Chinese film makers totaled \$2.7 billion).<sup>45</sup> It also found that about half of pirated films in China are Chinese movies.
- A Business Software Alliance study estimates that a 10 percentage point reduction in China's PC software piracy rates would raise its GDP by \$20.5 billion and create an additional 355,179 jobs.

Opinions differ as to why the Chinese government has been unable (or unwilling) to make a significant reduction in the level of piracy in China. Some explanations put forward by various analysts include the following:

- China's transformation from a command economy (in which the government owned and controlled nearly every aspect of the economic life) to one that is becoming more market-based is a relatively recent occurrence. Thus, IPR is a somewhat alien or unfamiliar concept for most people in China (as is the concept of private property rights) and consequently it is difficult for the government to convince the public that piracy is wrong.<sup>46</sup>
- Chinese leaders want to make China a major producer of capital-intensive and high-technology products, and thus, they are tolerant of IPR piracy if it helps Chinese firms become more technologically advanced.<sup>47</sup> A 2010 IIPA report contends: "China appears to have adopted an industrial policy in which such theft is a component driving Chinese competitiveness, or at a minimum, permitting free access to American content through unapproved pirate channels which simply ignore censorship controls but to which legitimate rights holders must adhere."<sup>48</sup>
- Although the central government may be fully committed to protecting IPR, local government officials are often less enthusiastic to do so because production of pirated products generates jobs and tax revenue, and some officials may be obtaining bribes or other benefits, which prompts them to tolerate piracy. The USTR's April 2009 report on IPR stated it was concerned by reports that government officials in China were urging more lenient enforcement of IPR laws because of the impact of the global financial crisis.

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<sup>45</sup> *Reuters*, "China Piracy Costs Film Industry \$2.7 Billion in 2005," June 19, 2006.

<sup>46</sup> Some Chinese officials have noted that some individuals who were arrested for IPR piracy violations expressed shock at their arrest because in their minds they were not harming anybody.

<sup>47</sup> On the other hand, IPR piracy may prevent foreign firms from investing in high-tech production in China.

<sup>48</sup> IIPA, *2010 Special 301 Report On Copyright Protection and Enforcement, People's Republic of China*, February 18, 2010, available at <http://www.iipa.com/rbc/2010/2010SPEC301PRC.pdf>.

- Pirated products, such as music, games, and videos, may be tolerated by the government because they provide China's citizens with diversions from politically sensitive issues.
- As a developing country, China lacks the resources and a sophisticated legal system to go after and punish IPR violators, and establishing an effective enforcement regime will take time.<sup>49</sup>
- As a practical matter, IPR enforcement in China will be problematic until Chinese-owned companies begin to put pressure on the government to protect their own brands and other IPR-related products. U.S. trade officials note that the Chinese government took aggressive action during the 2008 summer Olympics in Beijing to stop infringement activities.
- Chinese trade barriers and restrictive regulations on IPR-related products and their distribution are so onerous that they prevent legitimate products from entering the market, or raise costs so high that they are unaffordable to the average individual, thus creating a huge demand for low-cost pirated products.

### **The U.S. WTO Cases Against China on IPR**

On April 10, 2007, the USTR brought two IPR cases against China in the WTO involving a number of complaints.<sup>50</sup>

- The thresholds for criminal prosecutions of IPR violations in China are too high, meaning the government will only pursue cases it considers to be serious or excessively large, creating a safe harbor for smaller producers or violators. In addition, the thresholds for prosecuting IPR violations are based on the value of the pirated products rather than the value such legitimate products would fetch in the marketplace. Such thresholds make it very difficult to pursue cases against many commercial producers of illegal IPR-related products.
- The Chinese government often allows seized imported pirated goods to reenter the market rather than disposing of them.
- China's copyright laws fail to protect imported works (such as movies) that are under review by Chinese censorship authorities (and must be approved before the works can be distributed in China). As a result, pirated copies of the works can be widely distributed without violating copyright law and thus do not face prosecution.
- Chinese IPR laws do not appear to allow producers of pirated products to be prosecuted unless they also illegally distribute such products.
- China has not abided by its 2001 WTO accession agreement to liberalize its rules on trading rights and distribution services. As a result, U.S. IPR-related products face significant market access barriers in China, which drive up the price of

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<sup>49</sup> Some critics of this argument note that China seems to be very efficient at going after political dissenters and others deemed to be "threats" to social stability.

<sup>50</sup> See USTR April 9, 2007, Press Release and related documents at <http://www.ustr.gov/index.html>.

legitimate products, making them unaffordable for the average Chinese citizen, which in turn encourages high rates of piracy.

On January 26, 2009, a WTO panel ruled on the case dealing with IPR enforcement issues, finding that China failed to protect IPR works under review by the government for content and in regards to the disposal of seized pirated products. However, the panel determined that it needed more evidence on the issue of thresholds for criminal prosecutions of IPR piracy before a determination could be made. The USTR, while admitting disappointment on the WTO findings on thresholds, noted that, right before it filed the WTO case on China's IPR enforcement, China lowered its threshold criminal copyright threshold from 1,000 to 500 infringing copies. China has agreed to implement the WTO ruling.

On August 12, 2009, a WTO panel ruled that a number of China's restrictions on trading rights and distribution of IPR-related products (including reading material, audiovisual home entertainment products, sound recordings, and films for theatrical release) were inconsistent with WTO rules, namely discriminatory regulations on distribution services in China (where foreign firms are treated less favorably than domestic firms) and rules that designate only state-owned monopolies as entities that can import such products. However, the WTO panel did not address whether China's censorship policies, or its limits on the number of foreign films that can be imported, violated WTO rules. China agreed to implement the WTO ruling.

The USTR's 2010 Special 301 report stated that China continued to be a major focus of U.S. IPR concerns. It noted that, although China had made considerable progress in improving its IPR enforcement regime, IPR piracy rates remained at "unacceptable levels. In addition, USTR head Ron Kirk stated

we are seriously concerned about China's implementation of 'indigenous innovation' policies that may unfairly disadvantage U.S. IPR holders. Procurement preferences and other measures favoring 'indigenous innovation' could severely restrict market access for American technology and products. Creating an environment that nurtures innovation and entrepreneurship is a worthy goal, but China must maintain a level playing field.

During the December 2010 U.S.-China Joint Commission on Commerce and Trade (JCCT),<sup>51</sup> the Chinese government announced several new initiatives to improve its IPR protection regime, including boosting purchases of legitimate software by government agencies and 30 large state-owned enterprises.

## **Indigenous Innovation and Government Procurement Policies**

Numerous policies have been implemented in China to promote the development of industries deemed critical for future economic growth. The Chinese government's 11<sup>th</sup> Five-Year Plan (2006-2010) states that a central goal is to, within 15 years, change China from a major manufacturing center to a major global source of innovation. As a result of the plan, China has focused a large share of its research and development (R&D) on its space programs, aerospace development and manufacturing, renewable energy, computer science, and life sciences.<sup>52</sup> Nearly

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<sup>51</sup> The JCCT was established in 1983 to serve as a forum for high-level dialogue on major bilateral trade issues.

<sup>52</sup> *R&D Magazine*, December 22, 2009.

70% of the performance (as well as funding) of China's R&D comes from the government and about 21% from industry.

## Indigenous Innovation Policies

Several U.S. companies have complained about a number of Chinese government (from the central government as well as provincial and local government) circulars that would establish an "Indigenous Innovation Product Accreditation" system; this would give preferential treatment to locally developed technologies in government procurement. U.S. business representatives have sharply criticized the policy, which they contend is "protectionist" because it would require that public procurement projects provide preference to suppliers who have been accredited by the government as having developed their intellectual property in China. A letter written by the U.S. Chamber of Commerce and 33 business associations to the Chinese government on December 10, 2009, stated that the circulars would "make it virtually impossible for any non-Chinese companies to participate in China's government procurement market—even those that have made substantial and long-term investments in China, employ Chinese citizens, and pay taxes to the Chinese government." U.S. firms note that a large share of their technology is developed globally and thus it would be difficult to attribute the share of technology developed in China needed to obtain accreditation.<sup>53</sup>

China's proposed indigenous innovation policies were one of the top U.S. priorities at the May 2010 U.S.-China Strategic and Economic Dialogue (S&ED) (discussed below). The two sides reaffirmed that their innovation policies would be consistently based on non-discrimination; support for market competition and open international trade and investment; strong enforcement of IPR; and leaving the terms and conditions of technology transfer, production processes, and other proprietary information to agreement between individual enterprises. The two sides further agreed to conduct "intensive expert and high-level discussions" as early as the summer of 2010 on innovation issues and pledged to take into account the results of these talks in formulating and implementing their innovation measures.<sup>54</sup> During the December 2010 U.S.-China JCCT meeting, China stated that it will give equal treatment to all innovation products produced in China by foreign-invested enterprises and Chinese-invested enterprises alike.

## Chinese Government Procurement Issues

The U.S. Department of Commerce estimates that Chinese public procurement contracts are worth an estimated \$85 billion per year.<sup>55</sup> China has established a number of restrictive government procurement practices and policies. For example, in November 2008, China announced that it would implement a \$586 billion stimulus package, largely focused on infrastructure projects, in order to boost economic growth in the wake of the global economic slowdown. In June 2009, the government reportedly issued a circular with "Buy China"

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<sup>53</sup> Some analysts contend that one motive for the circulars is to force foreign companies to do more of their research and development in China in order to gain accreditation, thus enhancing China's access to technology, which the Chinese government will utilize to enhance its own technological advancement.

<sup>54</sup> U.S. Treasury Department Press Release, *Second Meeting of the U.S.-China Strategic & Economic Dialogue, Joint U.S. China Economic Track Fact Sheet*, May 25, 2010.

<sup>55</sup> U.S. Department of Commerce, *Remarks by Secretary of Commerce Secretary Gary Locke at American Chamber of Commerce and U.S.-China Business Council in Beijing, China*, May 18, 2010.

provisions requiring that projects funded by the stimulus package give preferences to domestic firms.

Government procurement policies are largely exempt from WTO rules, except for those members which have signed the WTO Government Procurement Agreement (GPA). The GPA is a plurilateral agreement among 41 WTO members (including the United States, Japan, and the 27 members of the European Union) that effectively provides market access for various non-defense government procurement projects to signatories to the agreement. Each member of the Agreement submits lists of government entities and goods and services (with thresholds and limitations) that are open to bidding by firms of the other GPA members.<sup>56</sup> WTO members that are not signatories to the GPA, including those that are GPA observers (such as China), do not enjoy any rights under the GPA. Nor are non-GPA signatories in the WTO generally obligated to provide access to their government procurement markets.

China formally entered negotiations to join the GPA in 2007 and made an official offer, but it was deemed unacceptable by the other WTO GPA parties. China promised to revise its GPA offer, but in October 2008, it notified the GPA parties that it was unable to provide a new offer.<sup>57</sup> During the October 2009 U.S.-China JCCT, China pledged that it would issue a new WTO GPA offer in 2010 and stated that it was the policy of China to treat products produced in China by foreign-invested enterprises the same as domestic products (and promised to issue new rules to clarify this point). At the May 2010 S&ED meeting, China pledged it would submit its revised GPA offer by July 2010, which it did on July 9, 2010. Although some analysts viewed China's latest GPA offer as an improvement over its previous offer, they contend that it fell far short of being acceptable to all the current GPA members. For example, the offer excluded purchases by local and provincial governments as well as state-owned enterprises. Congressional concerns over China's failure to join the GPA resulted in the introduction of legislation in the 111<sup>th</sup> Congress which would have imposed restrictions on U.S. government procurement of Chinese goods until China joined the GPA. During the December 2010 U.S.-China JCCT meeting, China agreed to submit a robust, new offer to the WTO Government Procurement Committee before the Committee's final meeting in 2011.

## **China and U.S. Trade Remedy Laws**

When China entered the WTO in 2001, it agreed to allow the United States to continue to treat it as a non-market economy for 12 years (codified in U.S. law under Sections 421 of the 1974 Trade Act, as amended) for the purpose of U.S. safeguards.<sup>58</sup> This provision enables the United States (and other WTO members) to impose restrictions (such as quotas and/or increased tariffs) on Chinese products when imports of those products have sharply increased and have caused, or threaten to cause, market disruption to U.S. domestic producers.<sup>59</sup> The Bush Administration on

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<sup>56</sup> GPA members are generally obligated to afford each other fair and non-discriminatory treatment for the covered procurement items and to maintain transparency in procurement practices.

<sup>57</sup> A Chinese official claimed they were having difficulties revising their offer due to potential conflicts with current Chinese procurement laws and the lack of consensus over which non-central government entities would be covered.

<sup>58</sup> China also agreed that the United States (and other WTO members) could continue to treat it as a nonmarket economy for antidumping cases for 15 years after accession. This provision enables WTO members to use third-country data to determine fair market prices when determining antidumping duties.

<sup>59</sup> Normally, safeguard provisions apply to all imported products. The China safeguard in U.S. trade law applies only to China. Unlike antidumping and countervailing cases, safeguard cases do not involve a contention that an unfair trade (continued...)

six different occasions chose not to extend relief to various industries under the China-specific safeguard, even though in four cases the U.S. International Trade Commission (USITC) recommended relief. A number of U.S. industries and labor groups have called on the Obama Administration to utilize the China safeguard provision, especially in the face of the current U.S. recession and because of “unfair” Chinese trade practices.

### **The Chinese Tire Case**

On April 24, 2009, the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union (USW) filed a petition with the USITC contending that U.S. imports of passenger vehicle and light truck tires from China caused or threatened to cause market disruption to U.S. domestic producers of like or directly competitive products. In June 2009, the USITC announced that it had determined such imports did in fact cause or threaten to cause market disruption, and recommended the imposition of additional tariffs over three years (55% in the first year, 45% in the second, and 35% in the third) and to provide expedited consideration of Trade Adjustment Assistance for firms and/or workers that are affected by such imports.<sup>60</sup>

The USW argued that the “extraordinary increase in imports” of tires from China had hurt tire producers in the United States and contributed to the loss of 5,100 U.S. tire-related jobs from 2004-2008, and that 3,000 more jobs would be lost in 2009. Producers of tires in the United States, many of whom have joint venture operations in China, did not express support for the safeguard case, and some actively opposed it.<sup>61</sup> Some industry representatives argued that a large share of U.S. tire imports from China were low-end products, that the USITC’s proposed increase in tariffs were excessive and punitive, and that such tariffs would hurt U.S. consumers and do little to boost employment in the U.S. tire industry. On September 11, 2009, President Obama announced that he would impose additional tariffs on certain Chinese tires for three years (35% in the first year, 30% in the second year, and 25% in the final year); these levels were less than the USITC’s recommendations.<sup>62</sup> China called the move protectionist and initiated a WTO trade dispute resolution case against the United States on September 14. In addition, on November 11, 2009, China launched antidumping and countervailing cases against U.S. autos and poultry, seen by many analysts as a retaliatory move over the U.S. safeguard measure on tires.

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practice is being used.

<sup>60</sup> The USITC determined that the U.S. tire industry had suffered a continuous decline from 2004-2008 in employment, hours worked, and earnings, and that producers’ domestic capacity, production, and shipments had fallen as well. It concluded that the sharp increase in tire imports from China was a major factor in this decline. See *USITC Publication 4085, Certain Passenger Vehicle and Light Truck Tires From China, Investigation No. TA-431-7*, July 2009.

<sup>61</sup> The USITC identified 10 tire producers in the United States, some of which are foreign-owned.

<sup>62</sup> Some analysts have speculated that the President’s decision was partly motivated by the belief that strong “enforcement” of U.S. trade laws would help induce lawmakers to support U.S. free trade agreements. See *Inside U.S. Trade*, “Reid, USTR See Tire Relief As Essential For Support Of Future Trade Deals,” September 10, 2009.



## Health and Safety Concerns Over Certain Imports from China<sup>63</sup>

Numerous incidents of unsafe food, consumer products (including seafood, pet food, toys, and tires), and medicines from China raised concerns in the United States (especially in 2007) over the health, safety, and quality of imports from China. Some analysts contend that China maintains a poor regulatory framework for enforcing its health and safety regulations and standards, and that this is proving to be a growing problem for U.S. consumers. Many U.S. policymakers have sought to press China to improve enforcement of its health and safety standards of its exports as well as the ability of U.S. regulatory agencies to ensure the health and safety of imports from China (and other countries).

There have been numerous recalls, warnings, and safety concerns involving Chinese products over the past few years, as the following examples illustrate.

**The Food and Drug Administration (FDA)** has been involved in a number of issues concerning foods and medicine from China.

- In March 2007, the FDA issued warnings and announced voluntary recalls on over 150 brands of pet food (and products such as rice protein concentrate and wheat gluten used to manufacture pet food and animal feed) from China believed to have caused the sickness and deaths of numerous pets in the United States.<sup>64</sup>
- In May 2007, the FDA issued warnings on certain toothpaste products (some of which were counterfeit) found to originate in China that contained poisonous chemicals.
- In June 2007, the FDA announced import controls on all farm-raised catfish, basa, shrimp, dace (related to carp), and eel from China after antimicrobial agents, which are not approved in the United States for use in farm-raised aquatic animals, were found. The FDA ordered that such shipments would be detained until they were proven to be free of contaminants.<sup>65</sup>
- On January 25, 2008, the FDA posted on its website a notice by Baxter Healthcare Corporation that it had temporarily halted the manufacture of its multiple-dose vials of heparin (a blood thinner) for injection because of recent reports of serious adverse events associated with the use of the drug, including 246 deaths from January 2007 to May 2008. The FDA determined that an active pharmaceutical ingredient imported from China was the source of the problem.<sup>66</sup>

<sup>63</sup> For additional information on this issue, see CRS Report RS22713, *Health and Safety Concerns Over U.S. Imports of Chinese Products: An Overview*, by Wayne M. Morrison.

<sup>64</sup> For a legal overview of FDA recalls, see CRS Report RL34167, *The FDA's Authority to Recall Products*, by Vanessa K. Burrows.

<sup>65</sup> In addition, FDA has refused shipments of a variety of Chinese food and drug products. See CRS Report RL34080, *Food and Agricultural Imports from China*, by Geoffrey S. Becker.

<sup>66</sup> Baxter stated "the contaminant had been chemically modified and was therefore so heparin-like in nature that it wasn't detected through standard, globally recognized quality tests that Baxter and its supplier perform on every batch of heparin. The presence of the substance in crude heparin indicates that the contaminant was introduced during the raw material stage, before it reached Baxter or its supplier, in what appears to be a deliberate scheme to adulterate a life-saving medication." The firm also noted that the majority of the world's supply of crude heparin comes from China, due to the large number of pigs required, and because there are insufficient supplies of this raw material in North America to meet the needs of the U.S. market. See Baxter website at <http://www.baxter.com/information/> (continued...)

Some analysts speculate that an unlicensed drug company in China, which produced ingredients for the drug, was the source of the problem.<sup>67</sup> FDA inspectors have reportedly inspected Chinese firms making raw heparin. However, several members of Congress have expressed concerns that the FDA has not adequately investigated potential problems concerning counterfeit or contaminated Chinese-made heparin.<sup>68</sup>

- On September 12, 2008, the FDA issued a health information advisory on infant formula in response to reports of contaminated milk-based infant formula manufactured and sold in China, and later issued a warning on other products containing milk imported from China. On November 12, 2008, the FDA issued a new alert stating that all products containing milk imported from China would be detained unless proven to be free of melamine. On December 2, 2008, the Chinese government reported that melamine-tainted formula had so far killed six children and sickened 294,000 others (51,900 of whom had to be hospitalized and 154 of whom were in serious condition).<sup>69</sup>

**The Consumer Product Safety Commission (CPSC)** has issued alerts and announced voluntary recalls by U.S. companies on numerous products made in China. Because China is the largest supplier of U.S. imports, especially consumer goods, its products have been subject to the largest number of recalls. For example, from January-December 2007, over four-fifths of CPSC recall notices involved Chinese products. Over this period, roughly 17.6 million toys were recalled because of excessive lead levels. Recalls were also issued on 9.5 million Chinese-made toys (because of the danger of loose magnets), 4.2 million “Aqua Dots” toys (because of beads that contained a chemical that can turn toxic if ingested) and 1 million toy ovens (due to potential finger entrapment and burn hazards).<sup>70</sup> China is the dominant supplier of toys to the United States, accounting for 90% of total U.S. imports (2009). U.S. recalls of lead-tainted Chinese-made toys were sharply down from 2007 levels, at 1.1 million toy units in 2008 and 1.2 million toy units in 2009, respectively.<sup>71</sup> However, there have been a number of recent reports that some imported toys from China contain high levels of the toxic chemical, cadmium, used in paint.

China and the United States have signed a number of agreements to boost cooperation, training, and communication on health and safety issues. For example, the CPSC and its Chinese counterpart (the General Administration for Quality Supervision, Inspection, and Quarantine) hold biennial consumer product safety summits to discuss major issues and to formulate cooperative work plans on priority issues (such as meeting U.S. standards on lead paint). In 2008,

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[safety\\_information/heparin\\_background\\_information.html](#).

<sup>67</sup> *New York Times*, “China Didn’t Check Drug Supplier, Files Show,” February 16, 2008.

<sup>68</sup> *The Hill*, “House Republicans Blast FDA on Handling of Blood Thinner Probe,” April 30, 2010.

<sup>69</sup> On October 15, 2008, the Chinese government issued an urgent notice to recall all dairy products made prior to September 14, 2008, so that they could be tested.

<sup>70</sup> For a list of company recalls of Chinese products, see the CPSC website at <http://www.cpsc.gov/cpscpub/prerel/prerel.html>. In addition, several U.S. retailers have announced that they have halted sales of certain Chinese products, due to health and safety concerns, which do not appear on the CPSC website.

<sup>71</sup> Congressional concerns over product safety led to the enactment of the *Consumer Product Safety Improvement Act of 2008* (P.L. 110-314) in August 2008. The law tightened requirements on children products, including mandatory testing. See CRS Report RL34684, *Consumer Product Safety Improvement Act of 2008: P.L. 110-314*, by Margaret Mikyung Lee.

the FDA opened offices in three major Chinese cities and in 2009 the CPSC opened an office at the U.S. embassy in Beijing.

## **Chinese Drywall**

There have been a number of media reports over the past two years about potential health and safety hazards of Chinese-made drywall products that have been installed in homes in several states over the past few years. The destructive results of hurricanes in 2004 and 2005 led to a sharp increase in U.S. demand for drywall, a significant amount of which was supplied by imports from China. The CPSC reports that it has received 3,756 reports (dating from December 2008 through the end of 2010) from residents in 41 states, the District of Columbia, American Samoa, and Puerto Rico who believe their health symptoms and/or the corrosion of certain metal components in their homes are related to the presence of drywall produced in China.<sup>72</sup> Major states affected include Florida, Louisiana, Mississippi, Alabama, and Virginia.

The CPSC and other federal agencies have sought to evaluate the relationship between the drywall and the reported health symptoms and electrical and fire safety issues, and to trace the origin and distribution of the drywall. Remedial actions to replace the drywall and the corrosive damages caused by emissions are likely to be quite expensive.

CPSC officials have also traveled to China to meet with Chinese officials and to inspect mines and drywall manufacturing plants. In November 2009, the CPSC announced that it had determined that there was a strong correlation between hydrogen sulfide emissions from certain (but not all) Chinese drywall to corrosion of metals in complaint homes. In April 2010, the CPSC announced that the top 10 reactive sulfur emitting drywall samples were from China. In May 2010, the CPSC released a list of drywall manufactures whose products emitted high levels of hydrogen sulfide. Some of the Chinese samples were found to have emission rates 100 times higher than non-Chinese samples. Several members have expressed concerns over homeowners affected by defective Chinese drywall. In 2009, the Congressional Contaminated Drywall Caucus was formed to ensure that the drywall issue was a priority issue in Congress. Many have argued that Chinese drywall firms, several of which are reportedly state-owned, should pay for damages. CPSC Chairman Inez Tenenbaum stated in May 2010: “I appeal to these Chinese drywall companies to carefully examine their responsibilities to U.S. families who have been harmed and do what is fair and just.”<sup>73</sup> A number of lawsuits have been filed in the United States against Chinese drywall producers.

## **The U.S.-China Strategic and Economic Dialogue**

On September 29, 2006, President George W. Bush and Chinese President Hu Jintao agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the “highest official level.” According to a U.S. Treasury Department press release, the intent of the SED was to “discuss long-term strategic challenges, rather than seeking immediate solutions to the issues of the day,” in order to provide a stronger foundation for pursuing concrete

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<sup>72</sup> See CPSC drywall information center website at <http://www.cpsc.gov/info/drywall/index.html>.

<sup>73</sup> CPSC Press Release #10-243, May 25, 2010.

results through existing bilateral economic dialogues.<sup>74</sup> The first meeting was held in December 2006. Four subsequent rounds of talks were held (the last was in December 2008).

While attending the G-20 summit in London on the global financial crisis on April 1, 2009, President Obama and Chinese President Hu agreed to continue the high-level forum, renaming it the U.S.-China Strategic and Economic Dialogue (S&ED). The new dialogue is based on two tracks. The first (the “Strategic Track”) is headed by the Secretary of State on the U.S. side and focuses on political and strategic issues, while the second track (the “Economic Track”) is headed by the U.S. Treasury Secretary on the U.S. side and focuses on financial and economic issues. Areas of discussion include economic and trade issues, counterterrorism, law enforcement, science and technology, education, culture, health, energy, the environment (including climate change), non-proliferation, and human rights.

### **The July 2009 Economic Track Session**

The first round of the S&ED was held in Washington, DC, on July 27-28, 2009, and involved 12 U.S. Cabinet officials and agency heads and 15 Chinese ministers, vice ministers, and agency heads. The session was focused heavily on issues relating to the global economic crisis. Secretary of Treasury Timothy Geithner stated: “Recognizing that cooperation between China and the United States will remain vital not only to the well being of our two nations but also the health of the global economy, we agreed to undertake policies to bring about sustainable, balanced global growth once economic recovery is firmly in place.”

The two sides agreed to establish a framework of cooperation based on four pillars:

- advancing macroeconomic and structural policies to achieve sustainable and balanced growth;
- promoting more resilient, open, and market-oriented financial systems;
- strengthening trade and investment ties; and
- strengthening the international financial architecture.

These pillars appear to have been aimed at deepening bilateral cooperation in response to the global economic crisis, continuing commitments by both sides to promote policies that seek to achieve more balanced economic growth, encouraging China to continue economic and financial reforms, expanding China’s role and/or participation in international economic forums,<sup>75</sup> and attempting to avoid new forms of protection.

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<sup>74</sup> U.S. Treasury Department press release, December 15, 2006.

<sup>75</sup> The United States is seeking to broaden China’s participation in international economic institutions in order to promote the goal of helping to make China a “responsible stakeholder” in the global economy. This implies that, since China’s greatly benefits from the global trading system and is a major global economy, it should shoulder a greater responsibility in maintaining and promoting that system (rather than just enjoying the benefits of that system). U.S. policymakers contend that if China accepts a greater leadership role in global economic affairs, it will induce Chinese leaders to consider how domestic economic policies can affect the global economy.

## May 2010 Economic Track Session

The May 24-25 S&ED economic session focused heavily on the continuing efforts relating to the four pillars identified in the July 2009 session. Although few concrete accomplishments were announced at the end of the meetings (such as on China's currency policy), the two agreed to intensify talks on a number of bilateral economic and trade issues. The two sides pledged to

- sign a cooperation protocol on small and medium-sized firms (SMEs);
- boost economic cooperation at the central and local government level, such as promoting the establishment of state-to-province and city-to-city partnerships;
- conduct “intensive expert and high-level discussions” as early as the summer of 2010 on innovation issues (such as China's indigenous innovation proposals) and to take into account the results of these talks in formulating and implementing their innovation measures;<sup>76</sup>
- improve cooperation to address health and safety issues relating to U.S. sales of soybeans to China;
- establish a cooperative mechanism between the U.S. Export-Import Bank and the Export-Import Bank of China on trade finance, and to develop initiatives to promote exports by SMEs;
- explore the possibility of cooperating to enable the United States to treat China as a market economy, and to treat certain Chinese firms as market-oriented industries, for the purpose of U.S. trade remedy laws; and
- boost investment opportunities and transparency.<sup>77</sup>

The effectiveness of the economic track of S&ED/SED process has been hotly debated. Some have praised the dialogue as a highly effective forum for dealing with major long-term bilateral economic (as well as environmental and energy) issues. A May 25, 2010, U.S.-China Business Council statement released on the May S&ED session said: “This year's meeting moved the ball forward on economic and commercial issues that affect American companies doing business with China. The S&ED is not meant to solve every issue between our countries, but these meetings are a vital part of the ongoing process of resolving issues that matter to American companies.”<sup>78</sup> On the other hand, some have criticized the process for failing to yield major concrete results on major trade economic and trade disputes. A statement released on the same day by the United States Business and Industry Council said: “The nearly 2,000 domestic companies comprising the U.S. Business and Industry Council (USBIC) today dismissed the just-concluded U.S.-China trade and economic talks as a ‘clumsy ruse’ aimed at fooling American voters into thinking that their leaders are meeting the threat of Chinese trade cheating.” The statement goes on to say that

<sup>76</sup> The United States also pledged that it would review Chinese concerns relating to U.S. restrictions on high technology exports to China resulting from the current U.S. export control regime.

<sup>77</sup> The United States pledged that it welcomed investment from China and confirmed that reviews foreign investment by the Committee on Foreign Investment in the United States ensures the consistent and fair treatment of all foreign investment without prejudice to the place of origin. China promised to revise its Catalogue Guiding Foreign Investment in Industries and encourage and expand areas open to foreign investment, including those relating to high-technology, energy, and the environment. China also pledged to streamline the process for investment approval.

<sup>78</sup> U.S.-China Business Council Press Release, May 25, 2010, available at <http://www.uschina.org/public/documents/2010/05/sed-strengthens-relationship.html>.

“Congress now needs to seize control from a President plainly beholden to outsourcing corporations and impose penalties on China’s currency manipulation and other trade cheating.”<sup>79</sup>

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<sup>79</sup> Statement by the U.S. Business and Industry Council, May 25, 2010, available at <http://www.tradereform.org/content/view/2639/52/>.